APPENDIX A

Review of Administrative Costs

Davies Associates,Inc

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Section I

Introduction

All utilities are now reporting administrative costs quarterly through the Collaborative, using the BPU definition and additional non-administrative costs definitions that the Collaborative has developed. However, since they have operated for less than a year there is little comparable cost information available regarding the administrative costs of the EE&RE (CRA) programs. Therefore, we tried to use the administrative costs of the DSM programs as a surrogate for the CRA costs.

The Financial section of the Audit Division was auditing the DSM administrative costs, concurrently with the commencement of this assignment. Davies Associates Incorporated (DAI) therefore decided to use their work rather than reinvent the wheel. Unfortunately, the Financial section could not identify the administrative costs of the DSM programs because:

- There was no consistent definition of administrative costs and what records available were inconsistent.
- The utilities' cost accounting records did not record DSM administrative costs as a separate item.
- Three of the utilities have upgraded to a new accounting system (SAP) and the records in the legacy systems were not always available.

Our review of the BPU financial audits found that the DSM administrative costs actually ranged from 0.4%-27%, due partly to inconsistent definitions. The average CRA administration costs for the year to date are 6.6%, excluding outsourced administrative costs, which could potentially be as high as another 22% (breakdown of operational vs. administrative outsourced costs not yet available). The DRA's guideline for administrative costs is 5%.

After discussions with the BPU project manager and the Audit Section DAI decided to concentrate on the current EE&RE (CRA) programs and ensure that a system for recording and reporting administrative existed, is and will be adequate and is used by the utilities.

The BPU following our request, agreed to a further audit that would establish that the administrative costs of the CRA programs, now being reported quarterly by the Collaborative, are consistent**.** This initial CRA Audit was inconclusive as some Utilities did not respond with the requested information on time and the auditors reported that they were not generally able to reconcile CRA administrative costs in the Utilities books to the Collaborative Administrative Cost Reports. We were advised that further in-depth audits will be undertaken in this regard.

If our recommended change to the counting of outsourced administration costs by contractors as administration (rather than as Implementation costs which are operational) is made, then these statements should represent an accurate statement of the costs of CRA program administration, notwithstanding the fact that the CRA programs are not focussed on the overall objective of market transformation.

Section II

Objectives

The Board's objectives for administrative costs, as set out in the terms of reference, were twofold:

1. Determine if the cost of the existing administration is appropriate
2. Decide upon the method of administering these EE&RE programs for the next three years.

The first objective was dependent on firstly obtaining the actual administration costs and their relationship to the programs, and secondly, whether the incidence of costs is appropriate.

The second objective is a function of how the EE&RE will be managed and organized for the next three years.

Societal Benefits Charges (SBC)

The history of the EE&RE programs in New Jersey is that an initial four year period was set by the Board (NJSA 48:3-60(a)(3)). Under the SBC, the

Board delegated the utilities to incur DSM and CRA program expenditures and to set these aside (including the program administration costs) in Deferred Accounts.

According to the Bureau Chief, Bureau of Rates & Tariff, BPU, all costs of DSM / CRA / Renewables programs are recorded for a $1 for $1 cost recovery. Costs must be “prudently incurred”. There are no definitions - unless the programs themselves have them. Costs are budgeted ahead of spending. Sometimes there is mandatory BPU spending for a market penetration level. Utilities are obliged to file to recover the costs, but there may be a rate cap (for electricity only), so any unrecovered costs will be deferred until the end of the transition period: August 2003.

Interest is paid to utilities on deferred costs at the regular BPU interest rate (same as a T-Bill). Note that SBC costs include the Remediation Adjustment Clause (RAC), - for restoring contaminated sites, include consumer education costs, in addition to regular DSM / CRA costs.

Each year, the utilities request repayment of these funds through an approved levy on rates, which is determined and adjusted when necessary. Any surplus or deficit not recovered that year in the Deferred Accounts is applied for, together with the current year’s expenditures, for recovery under the new rate approved in subsequent years. [1]

SBC costs are in effect a CRA rate tax on consumers, since rates are increased to cover program costs that the Utilities are approved to recover in due course. The fact that budgets are set in advance of expenditures and SBC levies de facto become retro-rate changes and that the SBC monies are kept by the Utilities in accounts which are bookkeeping entries, means that there is little control or oversight over them and of course they become interest free working capital, used for general corporate purposes, when they exceed the program costs expended, offset by accrued interest on the over-recovered balances. Such over or under-recovered balances are reviewed by both BPU staff and the Ratepayer Advocate on a periodic basis.

1 According to the Collaborative, SBC rates have been frozen from August 1999 through July 2003, which has lead to significant under-recovered balances and some utilities have had to borrow in the capital market to finance theses expenditures. Interest paid out is recovered from the SBC interest paid. Where there are over-recoveries the utilities use the surplus funds for general corporate purposes and compensates customers for the use of the funds by accruing interest on the over-recorded balance.

The chart shows the current SBC fund flow process.

Transition from DSM to CRA

In 2001, the utilities ceased their DSM programs and introduced CRA programs. When this review commenced in November 2001, CRA programs had been in place for only 8 or 9 months.

Reporting on the CRA programs was more formalized in that all the utilities were part of a Collaborative which expanded upon the previous BPU definition of administrative costs and required each utility to classify their program and administrative costs in a consistent reporting format.

The quarterly spreadsheet report (RA2T), of which three have so far been filed, shows the administrative costs for each utility and the roll up for the Collaborative as a whole.

Section III

Methodology

We changed our approach to suit the availability of data conducting the analysis in the following four steps:

1. Review the recently completed Financial Audits of DSM program administrative costs.
2. Review the BPU definition of Administrative costs and review the Collaborative's definitions in this area.
3. Conduct interviews with each utility on their accounting practices and methods of recording administrative costs in the CRA programs.
4. Review the administrative costs of similar programs in other States.

Analysis

We used the Financial Audits of the administrative costs of DSM programs as a surrogate for the limited experience of the utilities with the

CRA programs and report on these programs separately below. However, it was clear from the interviews held with the utilities individually, that, not only did we confirm the Financial Audit findings re administrative costs, but that the utilities often made no distinction between these programs, since the DSM programs folded into CRA programs. From the utilities' perspective, the difference is that for the CRA programs (and not all utilities had existing DSM programs, at least to the same extent), the Collaborative has provided the framework for the programs and for reporting of the administrative costs, which were not being reported on a formal basis before.

Status under DSM

The DSM financial audit reports[2] in general find that each utility has used different costs and revenues in determining what their administrative costs of the EE& RE programs are. This is mainly due to the fact that, prior to the CRA BPU definition of administrative costs (direct labor plus overhead - see below) was on a case by case basis for DSM for each utility and appears to have not gone into enough detail as to defining specific costs to be included or excluded and partly due to the fact that not all utilities had the same programs in effect and did not always classify their costs in the same manner. It is not clear how contracted-out expenses (which include administrative costs that some utilities do not contract out for) were treated under DSM.

As the audit of PSE&G (Electric) states,

> *" (Audit) Staff believes that any type of DSM administration that will be implemented in the future will require a review of the cost of DSM operations, including possibly an actual review of the company's accounting records and with the participation of auditors (BPU auditors or Outside Auditors)."*

In other words, formal monitoring of DSM costs should have been in place.

What costs were being included in DSM: the BPU definition of administrative costs for DSM programs was:

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[2] Note that at the time this report was prepared, the BPU had not discussed the findings of their DSM audits with the utilities.

> *"Administration Expenditures are direct utility labor, plus overheads, except for the costs that are appropriately allocated to any of the other expense categories, described below, plus the cost of facilities (including telephone, computers, supplies, etc) and legal support services"*

Administration Costs have also included the following cost elements that have been identified by the BPU auditors in their audit reports of DSM administrative costs:

- Direct Activity Allocation – Labor (DAA), Internal Settlement Activity (ISA)
- Internal Settlement Material - Materials (ISM)
- Internal Settlement External Services - Outside Services (ISE)
- Other Internal Settlement - Other (ISO)
- shared costs are either: incurred by one utility and cost recovered from the rest or: each utility pays directly to the suppliers
- interest at utility Return on Equity (ROE) approved by BPU
- lost revenue – only Fixed Costs (FC) (Standard Offer agreement)

= Total admin cost LESS Revenues on these programs.

(Source: PSE&G Audit quoting: 1999 Interim DSM Plan: Cost and Lost Revenue Recovery Mechanism)

In one audit, he auditors also found DSM administrative costs which were queried as contentious, such as consultant costs, a golf day for contractors, employee relocation expenses and cell phone charges.

Status under CRA

The BPU definition of administrative costs for the CRA EE&RE programs was uniform for the utilities in the Collaborative, whereas it had varied on a utility case by case basis for the DSM programs. The Collaborative has augmented this with definitions that define other non-administrative costs, but do not expand on the administrative cost definition per se.

In the Collaborative's report for CRA administrative costs, designated as Report RA2T, contracted out costs include those which are also administration costs and should more properly be include as administrative costs, contracted out. Some utilities for instance, undertake the process of energy rebate processing and check issuing, in-house, while others use contractors for this work. For the latest 12 months 2000-1, the average administration costs, excluding those outsourced, was 6.6%. If the outsourced administrative costs were included, administrative costs could rise by an estimated additional 10%, since total outsourced costs were 22% of total actual costs for CRA programs. However, until the Collaborative splits these costs out, our estimate of an additional administrative cost of 10% could be revised up or down.

Because the CRA programs have only been going for 8-9 months and only 3 quarterly reports were available, it was agreed that these reports do not show a consistent level of administration costs for the CRA programs, especially as there were heavy start-up costs incurred.

In interviews with the utilities it was noted that CRA programs tend to focus on the number of rebates processed and paid. Although this may be an intermediate proxy measure of how market transformation is being achieved (except that no utility could relate this to the total market penetration for rebates) no metrics for efficiency appear to have been established. For instance, measures of efficiency could be cost to process each rebate , time to approve and process the application for rebate, and net energy savings by type of consumer (some utilities did have selected information for this).

EE&RE Program Administration Costs in Other States

As a comparison with other States, New Jersey's incidence of administrative costs are reasonable, however, as discussed elsewhere in this report, the goals of many of these other States' programs are also not focused on market transformation.

California: the CEC is only allowed 2.5% for administrative costs

CN: 1-5% approved, although 7% may be claimed

Ill: no admin costs segregated

Mass: where these are approved the admin costs allowed by phase are:

Planning and Program Administration	8 percent
Marketing	3 percent
Rebates	45 percent
Implementation	31 percent
Evaluation and Research	2 percent
Performance	10 percent
Other	1 percent

Maine: N / A.

MD: N / A.

Montana: 7%

NY: 7% plus 2% for program evaluation

Oregon: up to 20%

Penn: N / A.

Texas: max 5%

VT: 27% plus cost of administrator

Wis.: actual cost of a ISA

(Sources: DAI interviews with State utility regulators)

Table of Administrative Costs CRA and DSM Programs.

	CRA Admin Costs- ***Average YTD 2000-1***	***DSM Admin Costs per Audits*** ***Actual Costs***
PSE&G Gas	6.0 %	1993-8: 2.5% - 7.4%
PSE&G Electric	6.3 %	August 1999 through July 2001 are on average: 1999 0.6%, 2000 0.4% and 2001 (6 months) 2.2%.
SJG	24.1 %	1991 at 16.9% to 33.6% (for seven months in 2001).
NJNG	9.4 %	N / A. Utility did not cooperate
EGC-NUI	10.1 %	average of 12.6% in the years 1994-2000 to 27.1% of total expenses for the year February 2000-January 2001
JCPL-GPU	5.0	Audit unable to quantify, but reasonable
Conectiv -ACE	8.9 %	Audit reported Admin expenses not identifiable
RECO	18.46 %	3% to 8%
TOTAL	6.6 %	N.A.

Notes:

CRA Admin costs are based on the Collaborative Report Spreadsheet RA2T for Admin costs, excluding outsourced admin costs, which are not yet available, but could be as high as another 10%, or lower than 10%.

DSM Admin costs are as reported in the BPU financial audits undertaken in December 2001; however, the auditors reported that recording of such costs was inconsistent and often historical costs were not always available; hence these percentages should be only used as a guide.

Section IV

Findings and Conclusions

DSM:

1. The BPU definition of administrative costs for EE&RE programs was terse, at too high a level and was interpreted by each utility in their own way. It bears reexamination in the light of the usage by the Collaborative in expanding it and in properly identifying administrative costs that are outsourced but currently reported as contracted out operational costs.

2. The Financial Audits carried out by the BPU confirmed that while many DSM administrative costs appeared to be reasonable, it was difficult to firstly obtain the budgeted and actual costs that had been charged to administration, and secondly there were inconsistencies in their application, if they were available. Consequently, the auditors found that administration costs for DSM programs, for which the DRA guideline was 5%, ranged from 0.4% to 27%.

3. Since DSM programs (and now CRA programs) differ widely by type (e.g. Energy Star and Renewables), and by phase (e.g. start up, information dissemination, heavy initial rebates, etc) it was not possible to state what a fair percentage for administrative costs by each program should have been, or what an overall administration cost should have been on average. However, had there been consistent identification and allocation of administrative costs, there should have been value in comparing such costs by time period, program, by utility.

4. The BPU did not undertake any regular monitoring of such administrative costs for DSM programs, consequently, no further disagregation of the high level definition was possible, nor were inconsistencies identified between utilities, nor were any comparisons made between similar DSM programs and the percentage each utility had incurred for administrative costs, either on a utility-wide basis or on a time/phase of the program basis. Thus the post-audits were inconclusive.

CRA:

5. The Collaborative has brought some consistency of reporting of administration costs to CRA programs, however, further analysis (now being undertaken by the BPU) is needed to ensure that each utility is reporting such expenses within the definition and consistently from period to period. A further sub-definition of administrative costs is not available by cost centers/chart of accounts, and outsourced administrative costs are separated from other contracted out program operational costs.

6. There were no variances from budget to actual costs computed, nor performance indicators of efficiency or level of service set up, which would complement financial administration costs and show how each program was performing in regard to efficiency and economy. (Note: this is aside from measures of program effectiveness, which are described in other Chapters)

7. The BPU is not monitoring CRA **rate revenues or** costs, nor does it appear to have the resources to provide oversight to so do.

Overall, we cannot make a conclusion as to whether the administrative costs of EE&RE programs are appropriate as:

- There is not enough data on the CRA programs and the data from the DSM programs was inconsistent
- The EE&RE programs have significant differences in themselves and thus the incidence of administrative costs will differ
- We have determined that the goals of the EE&RE programs are primarily to achieve Market Transformation and this objective has not been the focus of the CRA programs to date, the incidence of administrative costs is irrelevant, except that comparison between the administrative costs now being reported by the Collaborative for similar programs, normalized for size, in each utility, does give an indication of relative cost efficiency in total, albeit without formal metrics for efficiency having been set up.

Section V

Recommendations

DSM:

Our recommendation, since these programs are no longer in existence and administrative costs were not clearly identified or archived., is to focus on the CRA programs, where such costs can be properly identified, archived, monitored and reported on.

CRA:

In the next three years, for CRA programs:

1. The BPU should ensure that the utilities adopt mission based planning and budgeting in which the mission and critical success factors drive the selection of programs (see other Chapters) and the budget is the financial expression of the plan and a contract for performance**.** Achievement of the budget will demonstrate economy and efficiency in the expenditure of administrative costs.

2. As few as three of the utilities have SAP financial management software in place, a common activity-based costing system, using the revised administrative cost definitions for cost and responsibility centers. SAP should be put in place which can automatically produce the revised RA2T report. For the utilities which have not yet converted to SAP, there should be mapping of their cost centers to this report.

3. The BPU should ensure that there are key performance indicators for efficiency set up, i.e. for unit cost efficiency, for quality, timeliness and other levels of service fore each type of program. These will complement the effectiveness measures which will demonstrate the achievement of the overall goal of market transformation.

4. The BPU should set up CRA performance incentive payments for achievement of the metrics for efficiency, as is proposed for achievement of program output and outcome measures for effectiveness of achieving the market transformation goals.

5. The BPU should ensure that there is regular (at least quarterly) monitoring of the performance of the CRA programs, such that significant variances from Budget are explained, and that the other key performance indicators are computed and significant variances explained. Thus the monitoring of economy and efficiency will complement the monitoring of program outcomes of effectiveness.

6. The BPU should conduct regular audits and reviews on an individual utility and rolled up basis, to ensure compliance to the definition of administrative costs, that there is consistency of data and cost collection and reporting, as well as safekeeping and availability of historical accounting and operational records since the start of the CRA programs.

7. The BPU should order the Utilities to remit the SBC rate levy revenues to a segregated fund held by the BPU, so as to ensure greater control over these funds, to allow for audit of them and to earn investment income to contribute to or reduce the level of SBC rates. This would not affect the Utilities ability to recover these funds, since they would continue to apply for reimbursement of their CRA costs, which are kept by them in Deferred Accounts. The BPU would then issue payments on approving the audited CRA program expenses.

8. The BPU should also monitor other States and share information where there are similar types of programs, to ensure that the EE&RE programs are in the forefront or in line with these.